

## Client Newsletter November 2017

Welcome to the second Quartet newsletter of 2017. As always we hope you find it of interest and please do not hesitate to drop us a line if you have any questions or comments.

### Review of markets

Equity markets enjoyed a good summer, although European markets lagged as the European Central Bank signalled a possible reduction in monetary stimulus and BREXIT continued to cast a shadow. Japan and Emerging Markets outperformed as investors sought relative value, and the U.S. equity market benefitted from a recovery in commodity prices, a buoyant technology sector, and some optimism surrounding Trump's proposed tax cuts.

Volatility, as a measure of risk, stayed at historically low levels, displaying a level of complacency at odds with lofty valuations in certain sectors.

#### FTSE 100 Index (31 March 2017 – 31 October 2017)



Source: Portfolio Sharing

The UK equity market was largely range bound moving between 7,050 and 7,600 over the period

#### The Bond Market (31 March 2017 – 31 October 2017)

Bond markets continued to struggle as some Central Banks set out their intention to reduce monetary stimulus and raise interest rates. It was not surprising, therefore, to see Index-Linked Gilts underperform Conventional Gilts during the period given their greater sensitivity to interest rates.



Source: FE Analytics

31/03/2017 - 31/10/2017 Data from FE 2017

**Japanese Equities (Nikkei 225 Index):**



Source: Portfolio Sharing

Japanese equities are one of our key overweight positions in client's equity allocations. As such, the strong performance of Japanese equities during the period requires some attention. As has been the case so many times since the financial crisis, asset markets have been driven by Central Bank policy, and Japan is no exception.

We initiated a position in Japanese equities in 2013 in the expectation that the Bank of Japan would need to embark on a program of "QE" so that the yen might depreciate and stimulate the economy. Monetary policy has indeed been supportive of Japanese equities in recent years but now political and corporate reforms have become more influential on market expectations. Prime Minister Shinzo Abe consolidated his political powerbase in recent elections, providing another boost to investor confidence. The reforms he has implemented are more long-term and structural in nature than the short-term monetary fix that "QE" was designed to be, so for the time being we remain overweight Japanese equities.

## Portfolio Diversification; the What, Why and How...

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Given that constructing and managing diversified investment portfolios is at the core of what we do, we thought it worth revisiting the principles of diversification, to make it clearer why we value diversification as highly as we do and how we go about constructing portfolios.

### What is portfolio diversification?

Put simply, diversification is the practical way of avoiding “putting all your eggs in one basket”. In technical terms, portfolio diversification is the risk management strategy of combining a variety of assets that have differing behavioural characteristics in order to reduce the overall risk of an investment portfolio.

Provided the prices of these different investments do not move in unison with each other (i.e. are not closely correlated with each other), portfolio diversification should lower the volatility of a portfolio. By holding a variety of uncorrelated assets, one should significantly reduce unsystematic risk (the specific risks associated with each individual holding) in a portfolio.

### What does portfolio diversification achieve?

The purpose of portfolio diversification is ultimately about portfolio risk management. If portfolio diversification is implemented successfully, the level of risk within a portfolio should be lowered whilst retaining the ability to produce attractive returns. In other words, a correctly diversified portfolio should be able to create stronger risk adjusted returns than an undiversified portfolio.

By owning a diverse pool of investments across different asset classes, sectors and geographical areas, the industry and company specific risk of the portfolio is reduced as the assets should rise and fall at different times. The effect of all this should mean a smoother return profile over time.

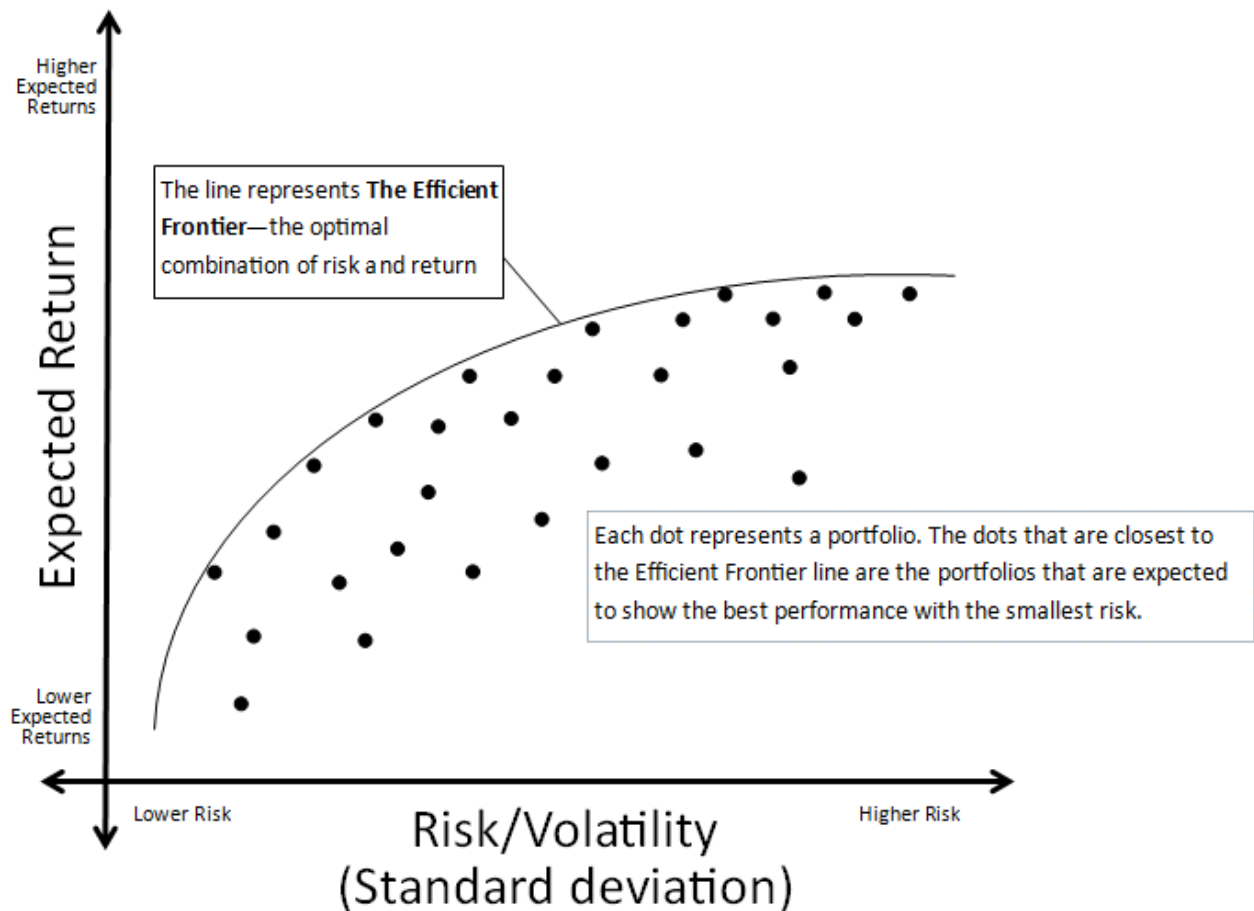
### How does one construct a diversified portfolio?

An “optimal” portfolio is one that maximises the trade-off between risk and reward, allowing for a client’s individual risk requirements and tolerances. There is a scientific process to ensure a portfolio is optimised and therefore tailored accurately to a client’s risk tolerance and portfolio objectives. The portfolio optimisation concept falls under modern portfolio theory, developed by leading economist Harry Markowitz in the 1950s. The theory assumes investors act rationally when making decisions aimed at maximising their return for their ascertained level of risk.

Portfolio optimisation demonstrates that it is possible for different portfolios to exhibit strong risk-adjusted returns, whilst carrying varying levels of risk. Each investor must decide how much risk they can assume and then allocate (or diversify) their portfolio according to this conclusion.

In modern portfolio theory, the efficient frontier is a set of investment combinations that occupy the points on the risk-return spectrum that offer the best returns for all given levels of risk. Formally, it is the set of portfolios which satisfy the condition that no other portfolios exist with a higher expected return but with the same standard deviation of return (risk).

The following chart illustrates how the portfolio optimisation actually works.



Asset Allocation (or portfolio optimisation) is both an art and a science. In a nutshell, portfolio optimisation is the process of refining and quantifying the risk and return characteristics of a certain mix of investments by compiling data from how the investments have behaved in the past. Without the portfolio optimisation process, multiple asset classes could be combined together in the hope that risk has been diversified away without actually having done so.

We essentially use three sets of historical data collected on individual assets (including investment funds and market-tracking instruments like ETFs), all modelled over the same long term backward-looking time period. These three sets of data are:

- Risk as measured by monthly standard deviation.
- Rate of Total Return (capital and income).
- The monthly correlation each holding has to the other investments in question. The correlation figures tell us how much an investment increased or decreased relative to the other investments over the same time period - a correlation of exactly 1.0 would mean the assets in question moved by exactly the same amount in the same direction.

Within a portfolio, it is desirable to hold a mix of assets that exhibit low levels of correlation to each other. When a portfolio is correctly diversified, there will always be assets in the portfolio that fall during rising equity markets but (crucially) rise during periods of market depression. We closely monitor correlations between the portfolio constituents, as their inter-relationship changes over time, to ensure that the mix of investments reduces the overall volatility, or risk, in portfolios.

## Outlook

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Our views for the remainder of 2017 and early 2018 remain broadly unchanged:

1. Whilst we had been expecting slow but positive economic growth with limited recession risk for the UK we think the impact of BREXIT on the UK could now result in a mild recession.
2. Although the US Federal Reserve (Fed) has started to raise rates we think the US market is potentially underestimating further rises. US growth remains reasonably robust and inflation has ticked up. We think the Fed may be behind the curve and may have to raise rates faster than is currently being priced in by the bond market.
3. Currencies remain a powerful force in markets and the path of the US dollar is, as ever, being closely watched. With the risk that the US Fed may raise rates more than expected we think the US Dollar will remain strong against other major currencies, while sterling continues to trade in its post-referendum range.
4. Equity markets continue to surprise us on the upside and should the Trump reflation package disappoint we think US equities will struggle. On the other hand we think there is decent upside potential in Japan and Europe where valuations are much less demanding. We expect volatility to rise from the current low levels due to increasing geopolitical risk.

## What alterations have we made to Quartet's client portfolios since 31 March 2017?

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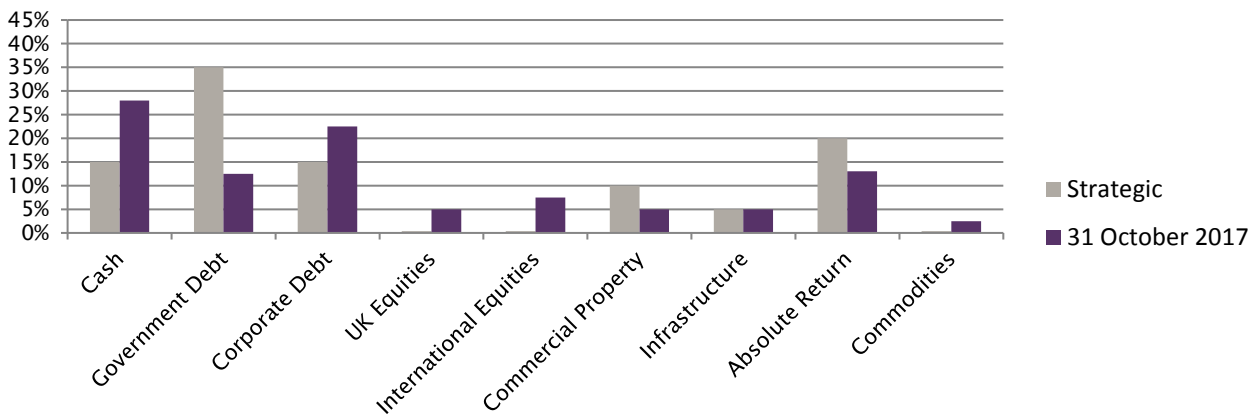
Our prime focus is on the management of client portfolio asset allocations, and as you will be aware the initial building block that we start with in the construction of each client portfolio is one of four strategic asset allocations as defined by the following risk profiles – Capital Preservation, Cautious, Balanced and Aggressive. These long-term asset allocations are then tailored to each client's circumstances to create a bespoke client portfolio. Client strategic asset allocations are then adjusted on a shorter-term basis depending upon our economic and investment views to arrive at our tactical asset allocations.

There have been changes across all risk profiles since 31 March 2017:

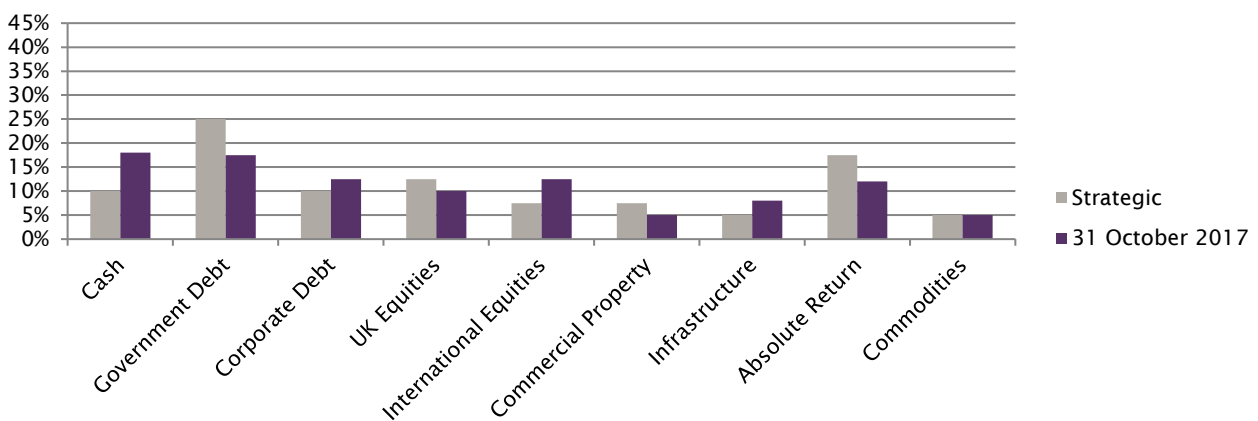
- We increased UK equity exposure early in the second quarter as credit signals indicated an improvement in U.K. economic conditions.
- We added a position in Infrastructure in most portfolios in June. Infrastructure produces an attractive level of income and contains some inflation linking which we view as vital at a time when U.K. inflation is rising.
- We sold the position in UK long/short equities in the second quarter. Due to low levels of market volatility we felt the strategy was unlikely to produce strong risk adjusted returns.

The following four charts show how our tactical asset allocations are positioned relative to the longer term strategic asset allocations.

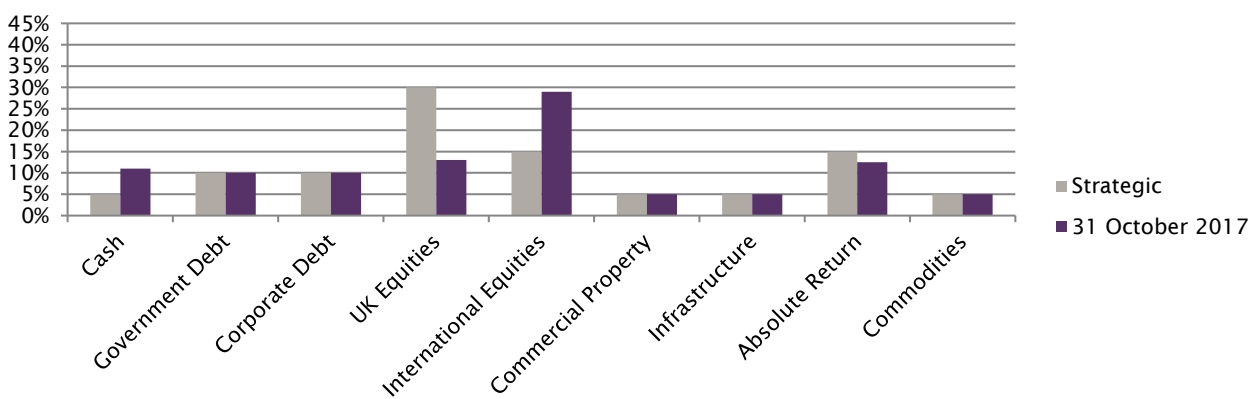
### Capital Preservation asset allocation



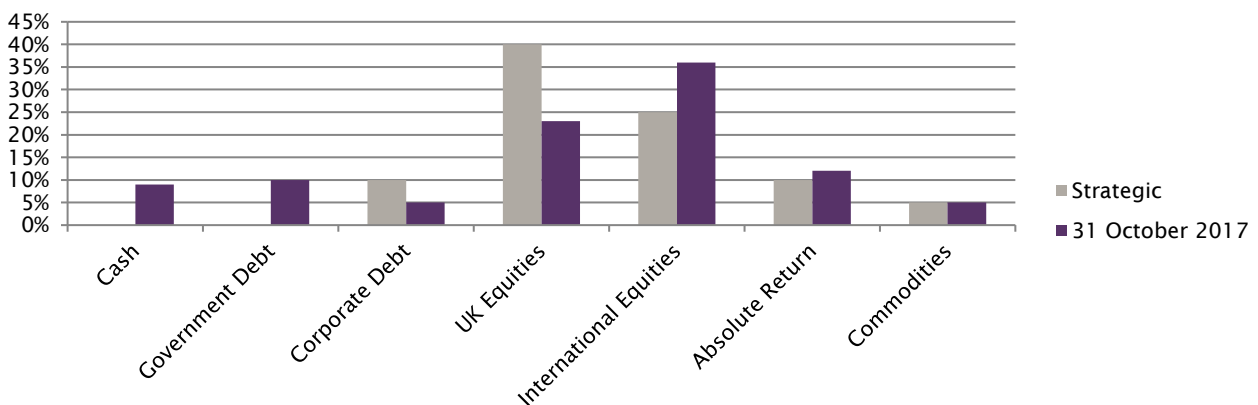
### Cautious asset allocation



### Balanced asset allocation



### Aggressive asset allocation



## **Comments on the difference between our current and strategic asset allocation positioning**

### **Cash**

Given our macro concerns and the current state of equity markets we are very overweight Cash across all portfolios. We are, however, investigating opportunities within the Alternatives asset class and hope to deploy some of our clients' cash balances in the coming weeks.

### **Government Debt**

We are significantly underweight conventional government debt across more cautious portfolios and have recently reduced our position in UK index-linked securities. We remain positive towards the US equivalent, TIPS, and retain exposure across all risk mandates.

### **Corporate Debt**

We are now neutral to marginally overweight conventional corporate debt exposure for all risk mandates. Whilst we expect some upwards movement in UK interest rates we think these are still some way off and will be implemented very gradually.

### **UK & International Equities**

We remain underweight the UK versus overseas where we see better opportunities. As highlighted earlier we continue to favour Europe, Japan and Emerging Markets at the expense of the US (where we think valuations are more stretched).

### **Commercial Property**

We have exposure to Commercial Property across most portfolios. Our sole investment holding leases Primary Healthcare Centres to the NHS so is in part an infrastructure investment. Capital growth has historically been in line with inflation but the yield is close to 7% per annum which we like in the current low interest rate environment.

### **Absolute Return**

At present we are marginally underweight this asset class. Absolute return strategies, we feel, will struggle without more long-term market directionality.

### **Commodities**

We now have minimal exposure to industrial commodities due to our concerns about growth rates in China and Asia. However, we remain very positive towards Agriculture over the long-term and therefore have exposure across all client portfolios.



## A reminder of what we do

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This has remained unchanged since we started the firm. We focus on providing discretionary investment management services to high net worth private clients. We believe the approach we take truly is **different**.

There are a few key points about Quartet's investment approach that make us different;

- **Bespoke portfolios.** We do not believe in shoehorning clients into predetermined investment solutions, all client portfolios are managed on a bespoke basis.
- **Portfolio construction.** We start by addressing each individual client's risk profile which in turn yields a strategic asset allocation. This is then adjusted tactically depending upon our macroeconomic views to finally arrive at a bespoke client portfolio.
- **Asset allocation.** We believe (and studies have shown) that asset allocation is by far the biggest driver behind investment performance. This is what we focus on getting right, and where we believe we add significant value.
- **Investments.** Very few fund managers consistently beat their respective benchmark index and they also tend to have high fees and costs. We therefore mainly use passive investment vehicles for core portfolio holdings. Tactical investments which make up the balance of most portfolios are specific investment counters or actively managed funds which are included to try and produce the best risk-adjusted returns (add alpha). All portfolios are managed on a multi-asset basis to diversify risk.

If you have any questions, comments or feedback, or if you are interested in a meeting with Quartet, please contact Quartet's Managing Partner, Colin McInnes ([cgm@quartet-im.com](mailto:cgm@quartet-im.com)), via email or on (020) 8939 2920.

## Quartet Investment Managers

November 2017

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